

EXECUTIVE SUMMARY

Chapter 1: The U.S.-China Trade and Economic Relationship

Trade and Economics Year in Review

China's economy grew at a 7.66 percent annualized rate in the first three quarters of 2013, continuing a three-year trend of decelerating output. This marked a significant decline from the three decades of growth in the 1980s, 1990s, and 2000s averaging 10 percent annually. Demand for China's exports stalled, and the domestic economy adjusted to a drop in government spending on massive infrastructure projects—undermining the two main pillars of China's economic surge over the previous decade.

China underwent a leadership change with a new president and premier and several new members of the Politburo and Standing Committee. No prominent political or economic reformers were elevated to the Politburo Standing Committee, China's highest decision-making body, though the backgrounds of Wang Qishan and Zhang Gaoli suggest that they might be open to further economic reform. There is uncertainty over the prospects for economic reform as a result of contradictory statements and actions by the new leadership. While there are signs that President Xi Jinping and Premier Li Keqiang are preparing a package of reforms to be unveiled at the Third Plenary Session of the 18th Central Committee, expected to take place in November 2013, President Xi has also been reaffirming the role of the state in the economy and introducing Maoist-style ideological campaigns aimed at stamping out political liberalization. In recent months, the government has introduced some important initiatives aimed at addressing some of the country's growing inequalities of wealth and opportunity. One initiative has been a focus on urbanization. The hope is that urbanization will become the next growth engine, initiating a new wave of investment, adding to the consumer class, and creating a surge in demand for housing and infrastructure. The urbanization drive may also boost Chinese efforts to make more land available for agriculture and improve farming efficiency.

Growing demand from China has supported exporters in certain sectors of the U.S. economy, such as aerospace, the auto industry, and agricultural products. However, the U.S. trade deficit with China continues to widen. In July 2013, the monthly deficit exceeded \$30 billion for the first time. Moreover, the Chinese government policies driving economic growth have resulted in what the International Monetary Fund (IMF) calls a "pattern of growth [that] has become too reliant on investment and an unsustainable surge in credit, resulting in rising domestic vulnerabilities." The most important—and most challenging—element of domestic rebalancing is increasing household consumption as a share of gross domestic

product (GDP), which has declined as a share of China's GDP for decades while the share of fixed-asset investment has grown.

China continues to intervene in foreign exchange markets to keep its currency undervalued. Such interventions, combined with China's subsidies to exporting industries, have helped China accumulate the world's largest foreign currency reserves—\$3.66 trillion by the end of September 2013. While maintaining a preference for government securities, China continues to diversify its foreign exchange assets. China's nonfinancial outbound foreign direct investment (FDI) for the first half of 2013 totaled \$45.6 billion, up 29 percent from the prior year. China rapidly accumulated foreign currency in 2013, but the pace of currency inflows varied during the course of the year. In the first quarter, currency inflows surged, followed by outflows in the second quarter as the country's banks encountered a liquidity crisis. These movements caused volatility in China's external accounts that carried over into the domestic financial sector.

Trends in Chinese Investment in the United States

China has amassed the world's largest trove of dollar-denominated assets. Although the true composition of China's foreign exchange reserves, valued at \$3.66 trillion, is a state secret, outside observers estimate that about 70 percent is in dollars. In recent years, China has become less risk averse and more willing to invest directly in U.S. land, factories, and businesses. This trend appears to be accelerating. In June 2013, China announced its largest purchase of a U.S. asset to date: a \$7.1 billion acquisition of Virginia-based Smithfield Foods, Inc. Given China's large holdings of U.S. dollars, China has a huge potential for FDI, particularly if China should substitute or abandon portfolio investment for direct investment.

The 12th Five-Year Plan (2011–2016) called for a three-pronged approach for increasing China's investment abroad. First, Chinese manufacturing companies should invest overseas in order to establish international networks and globally recognized brands. Second, Chinese companies should invest in research and development outside of China. Lastly, the plan set goals for shifting acquisitions toward sectors that promote a high-tech economy. This policy focused on investment goals in which domestic state-owned or state-controlled firms were already intended to be dominant by policy. These sectors included energy, machinery, construction, and information technology. The Chinese government wields many tools to drive these goals, including requiring permission for overseas investments by Chinese firms.

Despite China's large holdings of portfolio investment, China's FDI is still relatively modest. According to the U.S. Bureau of Economic Analysis, in 2012, the United States attracted \$174.7 billion of global FDI, of which only \$219 million came from China. Official estimates of Chinese FDI in the United States are too low, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, among other things. Chinese FDI in the United States has emphasized services, energy, and technology and is notable for its focus on brand acquisition.

State-owned enterprises (SOEs) have dominated Chinese FDI in the United States, making investments that follow the industrial policies of the Chinese government. Chinese SOEs receive substantial benefits from the central and provincial governments that are not available to their foreign competitors, including preferential policies and low cost of capital. Furthermore, SOEs investing in the United States may engage in particular predatory or anticompetitive behavior that U.S. trade remedies cannot address.

Trade-related aspects of foreign investments often intersect with national security concerns. For example, foreign intelligence collection efforts and espionage that target U.S. technology, intellectual property, trade secrets, and other proprietary information can be concealed under the pretext of foreign investment in cleared government contractors. The United States has a limited screening process for determining the potential national security threat from a specific foreign investment. The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee that reviews certain mergers, acquisitions, and takeovers of U.S. businesses by foreign persons, corporations, or governments for national security risks. China presents new challenges for CFIUS, because investment by SOEs can blur the line between national security and economic security. The possibility of government intent or coordinated strategy behind Chinese investments raises national security concerns. For example, Chinese companies' attempts to acquire technology track closely the government's plan to move up the value-added chain. There is also an inherent tension among state and federal agencies in the United States regarding FDI from China. The federal government tends to be concerned with maintaining national security and protecting a rules-based, nondiscriminatory investment regime. The state governments are more concerned with local economic benefits, such as an expanded tax base and increased local employment, rather than national strategic issues, especially as job growth has stagnated.

Governance and Accountability in China's Financial System

China's 12th Five-Year Plan calls for less dependence on exports and state-funded infrastructure projects and more domestic consumption to support China's economy. A shift from government-led to private-led growth requires that Chinese families and private sector businesses have sufficient access to credit and capital. Bank lending, the traditional source of credit for entrepreneurs and startups in most countries, is largely inaccessible to Chinese individuals and small- to medium-sized enterprises (SMEs), because China's financial system is dominated by large, state-owned banks that mainly service government-directed projects.

Banks hold a unique position in China and are even more important to the national economy than banks in Europe or North America, where alternate sources of financing are available. China's financial sector is dominated by five massive, state-owned commercial banks that account collectively for about 50 percent of all deposits and loans. Additionally, three policy banks were established in 1994 to take over government-directed spending functions like financing of major development projects. China's policy banks are funded primarily by selling bonds to the big commercial banks, and

all are ultimately back-stopped by the Chinese government. The incestuous relationship between the government; the large, state-owned policy banks; and their state-owned commercial cousins provides borrowers a considerable benefit: artificially low interest rates. The banks' depositors, meanwhile, are paid very low rates, sometimes below the rate of inflation, to help hold down the rates charged to borrowers. Thus, the state-owned corporate sector receives a subsidy from the bank's depositors (Chinese households) in the form of low interest rates.

A "shadow banking system" of unofficial credit has sprung up to fill the gaps left by the big banks' lending practices. China's shadow banking system can broadly be defined as lending that falls outside of the official banking system. It can involve both traditional and nontraditional institutions and is best understood not in terms of the institutions engaged in the system but in terms of the activities that they undertake. Because shadow banking activity occurs outside of formal banking channels, it does not appear on bank balance sheets and is far less transparent than official lending activity. Chinese demand for shadow banking is largely driven by the growth of China's private sector, a sector with limited access to official bank credit; and the Chinese government's tolerance of shadow banking in recent years has been tied to the reality that the private sector is the increasingly dominant source of the nation's employment.

Demand for credit has led Chinese companies to seek capital overseas even as its shadow banking system has expanded. In the late 1990s, Chinese companies began raising capital on major international stock exchanges. This trend has been driven by large Chinese companies, many state owned, that have sought to broaden their shareholder base, increase the liquidity of their shares, and enhance the visibility of their brand names. U.S. stock markets are among the most popular global exchange destinations for Chinese firms.

Initially, U.S. investors purchased stock in U.S.-listed Chinese companies in hopes of profiting from China's rapid growth rate. However, investors in U.S.-listed Chinese companies have increasingly found that insufficient corporate governance standards make these companies high-risk investments. Many have been implicated in frauds and accounting scandals, and U.S. regulators have deregistered about 50 Chinese companies in the past two years following fraud probes. During recent probes, the Securities and Exchange Commission (SEC) has sought audit work papers from Chinese branches of multinational accounting firms that service U.S.-listed Chinese companies, a common request during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secrets laws and subject them to criminal liability in China. In December 2012, the SEC charged five firms with breaking U.S. securities laws by refusing to turn over the requested audit work papers.

In May 2013, the United States and China announced a deal for limited information-sharing between their regulatory agencies when there are questions regarding audits of U.S.-listed Chinese companies. In July, Chinese regulators agreed to turn over certain

requested documents of some listed Chinese companies to assist the SEC in ongoing investigations. No agreement has yet been reached that would grant more general direct access to documents for U.S. regulators conducting investigations or inspections. Although it is considered a last resort option, if an agreement is not reached, the SEC and the Public Company Accounting Oversight Board could choose to ban Chinese accounting firms and Chinese branches of multinational accounting firms from auditing U.S.-listed Chinese companies, which could in turn lead to these companies being delisted from U.S. exchanges.

China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

China's World Trade Organization (WTO) accession in 2001 was a watershed event for U.S. agriculture. China is now the primary export market for U.S. agriculture products. While the United States ran a \$315 billion trade deficit in goods with China in 2012, it achieved a \$21 billion surplus in agriculture. Since full implementation of the WTO accession in 2005, China's agriculture imports from the United States have risen by an average of \$2.5 billion each year, exceeding the U.S. Department of Agriculture's (USDA) initial estimate of \$2 billion. China must feed a fifth of the world's population with less than a tenth of its arable land and potable water. As China transforms into an urban society with a growing middle class, per capita food consumption is rising and, with it, the demand for higher-protein diets—a demand that U.S. farmers are well positioned to fill.

There remain serious problems within the U.S.-China bilateral agriculture trade relationship, however. Many in the U.S. agriculture industry lobbied Congress in 2000 to grant China permanent normal trade relations, because they expected China to become a major purchaser of U.S. food products once it joined the WTO. But farm belt advocates have been disappointed that China has concentrated its purchases on bulk commodities, such as soybeans used as animal feed for China's outsized livestock industry. China's agriculture policy favors domestic production, even when it is unsustainable and nonessential to food security. In trade, China has used nontariff barriers to restrict imports of higher value-added products from the United States, including excessive subsidies; government control over import quotas; discriminatory taxes; and sanitary and phytosanitary restrictions that are not based on proper scientific analysis. These measures have contributed to an imbalanced food trade that has been particularly damaging to U.S. meat producers, who enjoy a comparative advantage over China in terms of resources, quality, and efficiency.

China's agribusinesses have pursued outbound investment in several countries and sectors in recent years. In the United States, this trend came into focus in June 2013, when Shuanghui International Holdings Limited, a subsidiary of Shuanghui Group, proposed to acquire the U.S. pork producer Smithfield Foods, Inc. As the largest U.S. pork producer, Smithfield is a strategic node in the U.S. food industry.

China's WTO accession was primarily envisaged as an opportunity for U.S. exporters. But U.S. consumer food imports from

China have surged as well, part of a greater reliance on imported food by U.S. consumers. The bulk of U.S. food imports from China consists of farm-raised fish and fruits and vegetables. China also supplies ingredients for U.S.-processed foods, as well as organic foods that are USDA-approved through third-party certifiers. For the United States, these imports from China present significant food safety risks. Over the past decade, China's major trade partners have repeatedly banned its food shipments on the basis of food safety. Current regulation of food entering the United States from China is insufficient. For one, the Chinese government's own food safety regulation is inadequate. The Chinese government in 2009 introduced a comprehensive Food Safety Law to establish a modern framework for food safety regulation and in 2013 created a China Food and Drug Administration to consolidate regulatory authority. However, it is uncertain whether these and other reforms will improve oversight of China's large and fragmented food industry.

In the absence of effective regulation by the Chinese government, U.S. consumers depend on U.S. food safety inspectors to provide protection against the importation of unsafe food products. The Food and Drug Administration (FDA), which is in charge of inspecting all nonmeat imports, is making substantial efforts to dedicate more staff and funding to China, to modernize its regulatory system, and to propose useful policies, such as foreign supplier verification. And yet, there are numerous problems with U.S. food regulation. The FDA still inspects only a fraction of the food that enters through U.S. borders. The agency has also found it difficult to increase on-the-ground inspections on the Mainland, in part because Chinese authorities have delayed visas for FDA inspectors and restricted access to food production sites.

Conclusions

Trade and Economics Year in Review

- China underwent a once-a-decade leadership change with a new president and premier and several new members of the Politburo and Standing Committee. The leadership indicated that China's overall economic policy goal—to transition from an export and investment-led growth model to a greater reliance on domestic consumption, remained the same. In reality, this change proved difficult to implement by a new government concerned about a slowing economy, real estate speculation, stagnating wages, and unemployment. The incoming government issued statements supporting a large and powerful state-owned sector in the economy, disappointing advocates of a larger private sector.
- The new Chinese leadership introduced initiatives aimed at reducing inequality, cracking down on corruption, and promoting urbanization. There are significant impediments to the government's ability to implement these reforms. For example, corruption is endemic at all levels of government, while local governments oppose urbanization due to fear that they will be overwhelmed by a flood of new migrants.

- China's progress in external rebalancing following the financial crisis was only temporary and largely driven by a weak global demand that reduced the relative size of China's export sector. Trade data for 2012–13 show that Chinese exports are again growing at a higher rate than imports, signaling a continued reliance on exports to fuel economic growth and a reversal in reducing China's massive trade surplus. As a result of failed measures to rebalance its economy, China has continued to expand its already record foreign currency reserves, reaching \$3.66 trillion by the end of September 2013.
- China's trade surplus with the United States in goods in 2012 was \$315 billion, a record. For the first seven months of 2013, China's trade surplus with the United States was \$178 billion, also a record. China continues to manipulate the value of its currency, the RMB, to achieve a competitive advantage with the United States. China also continues to follow mercantilist policies to foster a trade surplus with the United States.
- China has had little success transitioning toward a consumption-led growth model and reducing its reliance on massive infrastructure projects to boost economic growth. Consequently, China's high investment levels have led to overcapacity in multiple industries, including steelmaking, shipbuilding, and solar panel manufacturing. A slowdown in urban household disposable income growth and an increase in the household savings rate have cut into consumer purchasing power and contributed to a decline in total retail sales growth.
- Chinese officials have played down the significance of lower growth, saying the slowdown is partly due to economic rebalancing. However, the government continues to stimulate the economy through a variety of small steps. For example, the State Council, China's cabinet, instituted a temporary tax cut (scrapping all value-added and operating taxes) for more than 6 million small- and medium-sized enterprises; reduced approval procedures and administrative costs for exporting companies; and provided more investment in railway construction in China's central and western regions. In a similar vein, securities regulators and the central bank issued record amounts of investment approvals to the Qualified Foreign Institutional Investors program.
- Due to its restrictive monetary policy, China's central bank has accumulated the world's largest foreign exchange reserves. The bulk of these reserves are invested in U.S. Treasury securities, so that Chinese ownership accounts for nearly one-quarter of foreign-owned U.S. Treasuries. In addition, China's two largest sovereign wealth funds, China Investment Corporation and SAFE Investment Company, have expanded their equity and real estate investments in the United States.
- The People's Republic of China (PRC) has concluded 13 trade agreements, the latest with Iceland and Switzerland this year—the first signed with European governments. China is in the process of negotiating six additional trade agreements, which include the ASEAN-led Regional Comprehensive Eco-

conomic Partnership, an initiative to link ASEAN member states and preferential trade agreement partners to form the world's largest trading bloc. The Regional Comprehensive Economic Partnership, which excludes the United States, is competing with the U.S.-led Trans-Pacific Partnership, which excludes China. Formal negotiations of the Regional Comprehensive Economic Partnership began in May 2013 and are scheduled to conclude by the end of 2015.

- China's attempts to keep the value of the RMB artificially low while strictly limiting the flow of RMB from the country, coupled with its efforts to control a large state banking sector, led to a banking crisis. The collapse in liquidity threatened economic growth in China and demonstrated the difficulty of conducting a monetary policy so at odds with its trading partners and international norms.
- The fifth round of the U.S.-China Strategic and Economic dialogue was held on July 10–11, 2013, in Washington, DC. There were no significant achievements in the strategic track. On the economic front, the most relevant announcements were (1) resumption of bilateral investment treaty talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China's financial sector. In the multilateral arena, the United States successfully challenged China's improper imposition of antidumping and countervailing duties at the WTO.
- China continues to take incremental steps toward RMB internationalization, but the goal of making the RMB a major international currency remains out of reach as the government continues to maintain strict controls on cross-border capital flows.
- Beijing's efforts to reform the financial system continue to be hampered by risky off-balance-sheet lending by banks and nonbank financial institutions. Beijing has undertaken efforts to curb these risky lending practices, removing the floor on lending rates and imposing a short-term credit crunch in a clumsy effort to send a strong signal to the financial sector. However, there is little evidence so far that these efforts have succeeded. The ceiling on rates paid to depositors remains low, and some risky lending actually increased during the credit crunch.

Trends in Chinese Investment in the United States

- Chinese foreign direct investment (FDI) in the United States continues to grow, though from a very low base. According to official U.S. statistics, in 2012 the United States attracted \$174.7 billion of global FDI, of which \$219 million came from China. An estimate by country of ultimate beneficiary owner, which better tracks actual investors, put stock of Chinese FDI in the United States at \$9.5 billion at the end of 2011. For the same year, China's Ministry of Commerce put the flows of Chinese FDI to the United States at \$1.8 billion, with stock of FDI estimated at around \$9 billion.

- Official statistics underestimate the true volume of Chinese investment, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points for Chinese money on the way to the real investment destination. Official data are also provided after a significant delay, which hinders analysis.
- To date, state-owned enterprises (SOEs) have dominated Chinese FDI in the United States measured by the value of deals, though private companies lead by the number of deals. One reason is that the biggest investments so far have been made in the oil and energy fields, which are dominated by Chinese state-owned giants.
- Chinese investors have primarily targeted those sectors where China lacks know-how and technology, particularly in the Strategic and Emerging Industries identified in the 12th Five-Year Plan. Energy and services (in particular real estate and financial services) have received the most investment. High-end manufacturing is another important destination for China's investments, particularly when measured in terms of the number rather than the value of deals.
- Due to the considerable government ownership of the Chinese economy, provision by Chinese companies of critical infrastructure to U.S. government or acquisition by Chinese companies of U.S. firms with sensitive technology or intellectual property could be harmful to U.S. national interests. The Committee on Foreign Investment in the United States (CFIUS) investigates the national security implications of mergers and acquisitions by foreign investors of U.S. assets.
- Investigations by CFIUS and other national security review and mitigation mechanisms may be hampered by limited resources or limited statutory authority.
- Investments made by Chinese state-owned or -controlled companies can also pose economic security threats. The Chinese government provides significant financial and logistical support. This puts U.S. firms, which receive no such support, at a competitive disadvantage. When Chinese SOEs invest abroad, they do not necessarily seek profit and may instead pursue government goals such as resource acquisition or technology transfer.
- Chinese investments in the United States are subject to the same set of rules and regulations as investment from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they will be subject to legal sanction. But gaps exist in the U.S. government's ability to address the competitive challenges posed by SOEs.
- In areas where there are no national security considerations, and when the investment is driven by economic rather than strategic rationale, Chinese FDI can benefit the U.S. economy through creation of jobs and other positive spillovers.

Governance and Accountability in China's Financial System

- The Chinese economy weathered the first few years of the global economic downturn by doubling down on its time-tested strategy of funneling capital into domestic development projects. But five years on, global demand for Chinese exports remains too weak to sustain the country's factories, much less new ones, and the merits of massive infrastructure projects have more than run their course. The policy decisions that kept the Chinese economy chugging over the last few years have also sped it closer to a reckoning that economists have long forecast would eventually be necessary. If a rebalancing of the U.S.-China economic relationship is to be achieved, China must reform its financial system to support newer, nonstate sources of economic growth, which will require that China's banks better service its private sector.
- As long as China's official, regulated channels of credit do not possess the flexibility to meet the needs of the Chinese economy's main job creators, China will be at risk of depressed economic growth, which in turn may limit the growth of U.S. exports to China and the prosperity of U.S. investments in China, slowing economic recovery here at home. The shadow banking system that Beijing has allowed to step into this credit gap is insufficiently regulated and, if left unchecked, will pose an increasingly serious threat to Chinese and global economic stability.
- The opacity of Chinese corporate governance and accountability policies, as well as conflicts with U.S. securities laws and regulations, hurts investor confidence in Chinese companies trading on U.S. exchanges. The current situation threatens U.S. investors with unforeseeable and unmanageable losses and may lead to a broad delisting of Chinese companies. China's lack of sophisticated banking, corporate governance, and auditing policies and practices also hinders much-needed growth and opportunity for the very U.S. financial services firms that could help China to restructure its system if they were allowed greater access to the Chinese market.
- Insufficient transparency and accountability in China's financial sector put U.S. firms at risk of violating laws in both China and the United States; pose unreasonable hazards for U.S. investors with shares in Chinese companies; and render some U.S. laws and regulations unenforceable. Without greater regulatory transparency and assurance of China's regulatory, oversight and enforcement capabilities, Chinese firms also risk curtailment or even revocation of access to the U.S. market.

China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

- For the past three years, China has been the largest export market for U.S. agricultural goods. However, trade is far from free, and enormous opportunities are being withheld. China's WTO accession has not been as productive to the United States as initially expected. In contrast to U.S. agricultural exports to

the rest of the world, most U.S. exports to China are bulk commodities, particularly raw soybeans that supply China's out-sized livestock sector. Conversely, processed commodities, meat products, consumer foods, and other higher value-added products have not kept pace with the overall growth in bilateral trade.

- Since the 1980s, China has developed into the world's largest agricultural economy, producing a fifth of the world's grains, a quarter of its meat, and half of its vegetables. But demand in China is beginning to outstrip supply. As more people move to cities and earn higher incomes, China's population is demanding safer food and a more diverse, protein-rich diet at an affordable cost. The United States is well-positioned to meet that demand. U.S. farmers enjoy a comparative advantage in resources, productivity, and quality, particularly in meat production.
- China's agriculture policy favors domestic production over imports. China maintains ambitious self-sufficiency targets that are unsustainable and unjustifiable in terms of food security. This policy is now being challenged by the decline in China's farm labor surplus, deteriorating land and resource endowments, and fragmented producer and land use systems. A related problem is that efforts to modernize agriculture conflict with rural welfare aims. Millions of rural migrants continue to rely on farmland and smallholder agriculture for insurance in the absence of a functioning welfare state.
- China has failed to fully perform its obligations under the WTO. It has erected a series of nontariff barriers that include state trading; excessive domestic subsidies and stockpiling of commodities; discriminatory taxes; uncalled-for antidumping duties; and slow approvals of biotechnology applications for U.S. crops. Damaging to U.S. interests as well are sanitary and phytosanitary restrictions, especially BSE-based bans on beef and zero tolerance for ractopamine in pork. Although China has significantly lowered its tariffs and increased its agricultural imports since accession, numerous trade restrictions remain in place.
- U.S. companies, universities, and government agencies are helping China to improve the quantity and quality of its food output. In a sign of deepening bilateral ties, the United States and China signed the first U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017) in February 2012, and in March of that year the largest-ever U.S. agricultural trade mission visited China. However, U.S. companies operating in China are hamstrung by regulatory uncertainty, restricted market access, and weak intellectual property enforcement.
- China is fostering globally competitive agribusinesses, in the process becoming an active acquirer of agricultural assets overseas. In June 2013, China's largest pork producer, Shuanghui, proposed a \$7.1 billion acquisition of Smithfield, the leading pork producer in the United States. While the deal has been approved by CFIUS and Smithfield's shareholders, it raises

critical issues regarding net economic benefits, intellectual property, reciprocal market access, and the treatment of quasi-private Chinese companies that maintain links to the Chinese government.

- China accounts for a large share of the fruits, vegetables, fish, and processed foods that Americans consume, but the United States has little assurance that the food imports coming into the United States from China are safe. China's own food safety regulation is still ineffective, in spite of recent efforts to consolidate agencies and improve legislation. U.S. consumers rely on U.S. food safety inspectors to do their jobs, but U.S. regulation is also fragmented and underfunded. U.S. regulators have increased their presence within China but have struggled to obtain work visas and to gain access to food production facilities. Although the United States does not permit raw meat imports from China, the USDA has granted equivalence status to Chinese poultry processors, which will permit them to process poultry raised in the United States and Canada and ship it to the United States.

Chapter 2: China's Impact on U.S. Security Interests

Military and Security Year in Review

China's late 2012 leadership transition brought the largest turnover to the Central Military Commission (CMC) in a decade. Xi Jinping assumed the position of both CMC chairman and Chinese Communist Party (CCP) general secretary at the CCP's 18th Party Congress on November 15, 2012. President Xi then completed his accession as China's senior leader by becoming the People's Republic of China (PRC) president on March 14, 2013. Although President Xi was widely expected to eventually assume all three of China's top leadership posts, many observers were surprised by the speed of his elevation to CMC chairman. Mr. Hu broke with the pattern established by his two predecessors, who retained the CMC chairmanship for two years after finishing their terms as CCP general secretary.

Since becoming CMC chairman, President Xi has used public speeches and visits to People's Liberation Army (PLA) units to reaffirm China's long-term military modernization goals; emphasize the importance of a strong military to the fulfillment of the "China Dream," his new political slogan and party campaign; and signal his intent to focus on increasing combat readiness and reducing corruption in the PLA.

In November 2012, President Xi introduced the "China Dream" concept, which envisions the "great renewal of the Chinese nation" and the advancement of an international system in which China's successful rise provides an attractive alternate political model to Western ones. Achieving the dream means building a "moderately prosperous society" by 2021 and a "modern socialist society that is strong, democratic, cultured, and harmonious" by 2049. Although President Xi emphasizes that "peaceful development" and a stable regional environment are essential to create the conditions for this vision, he linked its fulfillment to a strong military in a

December 2012 speech while aboard a PLA Navy destroyer. In June 2013, official PLA media explained, “To the armed forces, the China dream is the strong-army dream, the China dream leads the strong-army dream, and the strong-army dream supports the China dream.”

During his first reported visit to a PLA base as CMC chairman in December 2012, President Xi called for the PLA to increase “combat readiness” through “realistic training.” Combat readiness has been a central theme of subsequent speeches to the military by President Xi and now features prominently in official PLA statements and documents. For example, official PLA media in January 2013 said the military needs to prevent and overcome the “harmful” practice of training “for show.” Furthermore, describing the PLA’s 2013 training priorities, a PLA official said: “The ‘scent of gunpowder’ in the ‘fighting’ will be stronger. The entire military will make ‘training like real war’ . . . the main theme of the entire year’s training, powerfully strengthening training of mission topics, ensuring that as soon as there is a situation, the military will be able to go forward and fight to victory.”

In a meeting shortly after becoming the CMC chairman, President Xi urged senior PLA officers “to take a firm stand against corruption” and to maintain a “strict work style” and “iron discipline.” Since then, reducing corruption and waste in the PLA has been one of President Xi’s most consistent messages in his public speeches to the military. In addition to rhetoric, President Xi has announced stronger anticorruption regulations for the PLA, including restrictions on military personnel holding banquets, drinking excessive amounts of alcohol, and using luxury hotels.

In March 2013, China announced its official defense budget for 2013 rose 10.7 percent to 720.168 billion RMB (approximately \$117.39 billion), signaling the new leadership’s support for the PLA’s ongoing modernization efforts. This figure represents 5.3 percent of total government outlays and approximately 1.3 percent of estimated GDP. China’s official annual defense budget now has increased for 22 consecutive years and more than doubled since 2006. The Institute of International Strategic Studies assesses China’s actual defense spending is 40 to 50 percent higher than the official figure. The U.S. Department of Defense (DoD) estimated China’s actual defense spending in 2012 fell between \$135 and \$215 billion, which was approximately 20 to 90 percent higher than China’s announced defense budget.

In April 2013, China released the latest version of its biennial defense white paper. This is the first defense white paper published since President Xi became CMC chairman. Although Chinese military leaders likely began to draft the document before President Xi assumed the position, official Chinese press suggests it contains strategic priorities specific to him. Official Chinese media hailed the 2012 defense white paper as a milestone in transparency, citing the “declassification” of military information. However, most of this was widely-known information that Beijing had never officially acknowledged. Furthermore, as in previous iterations, the 2012 defense white paper offers no substantive information on important defense issues.

Since commissioning its first aircraft carrier, the *Liaoning*, in September 2012, the PLA Navy has continued to develop a fixed-wing carrier aviation capability for air defense and offensive strike missions. China plans to follow the *Liaoning* with at least two indigenously built carriers. The first likely will enter service by 2020 and the second by 2025. China's Julang-2 (JL-2) submarine-launched ballistic missile (SLBM) is expected to reach initial operations capability by late 2013. The JL-2, when mated with the PLA Navy's JIN-class nuclear ballistic missile submarine (SSBN), will give China its first credible sea-based nuclear deterrent. The SLBN/SSBN weapon system will be able to target the continental United States from China's littoral waters.

The PLA Navy continues to steadily increase its inventory of modern submarines and surface combatants. China is known to be building seven classes of ships simultaneously but may be constructing additional classes. China also recently began developing its first sea-based land attack capability. Modern submarines and surface combatants equipped with land attack cruise missiles (LACMs) will enhance Beijing's flexibility for attacking land targets throughout the Western Pacific, including U.S. facilities in Guam.

China also continues to pursue new space and counterspace capabilities. In May 2013, China fired a missile into nearly geosynchronous Earth orbit, marking the highest known suborbital launch since the U.S. Gravity Probe A in 1976 and China's highest known suborbital launch to date. Although Beijing claims the launch was part of a high-altitude scientific experiment, available data suggest it was intended to test at least the launch vehicle component of a new high-altitude antisatellite (ASAT) capability. If the launch is part of China's ASAT program, Beijing's attempt to disguise it as a scientific experiment would demonstrate a lack of transparency about its objectives and activities in space. Furthermore, such a test would signal China's intent to develop an ASAT capability to target satellites in an altitude range that includes U.S. Global Positioning System (GPS) and many U.S. military and intelligence satellites. Throughout 2013, China also made significant advances in its manned space and regional satellite navigation programs. The PLA's extensive role in China's civilian space programs suggests these activities support the development of PLA space, counterspace, and conventional capabilities in addition to serving China's overall development strategy.

In late January 2013, China conducted the first test flight of its indigenously developed cargo transport aircraft, the Yun-20 (Y-20). China previously was unable to build heavy transports, so it has relied on a handful of Russian aircraft for strategic airlift since the 1990s. Once large-scale deliveries of the new plane begin, the Y-20 aircraft will be able to support a variety of domestic and international military operations. The Y-20 will enhance the PLA's ability to respond to internal security crises and border contingencies, support international peacekeeping and humanitarian assistance operations, and project power in a regional conflict.

In June 2013, the PLA Air Force began to receive new Hongzha-6K (H-6K) bomber aircraft. The H-6K has an extended range and can carry China's new long-range LACM. The bomber/LACM weapon system provides the PLA Air Force with the ability to conduct

conventional strikes against regional targets throughout the Western Pacific, including U.S. facilities in Guam. Although the H-6K airframe could be modified to carry a nuclear-tipped air-launched LACM, and China's LACMs likely have the ability to carry a nuclear warhead, there is no evidence to confirm China is deploying nuclear warheads on any of its air-launched LACMs.

In July 2013, the PLA began to deploy peacekeepers to the United Nations (UN) Multidimensional Integrated Stabilization Mission in Mali (MINUSMA). The PLA contingent includes what Beijing calls a "security force" from a PLA group army. This marks the first time Beijing has deployed infantry to support a peacekeeping operation since it began participating in UN missions in 1990. China previously had limited the PLA's participation in peacekeeping operations to noncombat troops.

China's Cyber Activities

In 2013, strong evidence emerged that the Chinese government is directing and executing a large-scale cyber espionage campaign against the United States. Mandiant, a private U.S. cybersecurity firm, issued a report that provides evidence that the PLA since 2006 has penetrated the networks of at least 141 organizations, including companies, international organizations, and foreign governments. These organizations are either located or have headquarters in 15 countries and represent 20 sectors, from information technology to financial services. Of the organizations penetrated, 81 percent were either located in the United States or had U.S.-based headquarters.

The Mandiant report was followed by DoD's first direct accusation that the Chinese government and military are conducting cyber espionage against U.S. networks. DoD's 2013 annual report to Congress on China's military stated: "In 2012, numerous computer systems around the world, including those owned by the U.S. government, continued to be targeted for intrusions, some of which appear to be attributable directly to the Chinese government and military." Previously, DoD had stopped short of attributing cyber espionage to the Chinese government or military, instead merely acknowledging cyber espionage "originated" in China.

There are no indications the public exposure of Chinese cyber espionage in technical detail throughout 2013 has led China to change its attitude toward the use of cyber espionage to steal intellectual property and proprietary information. It is clear naming and attempting to shame will not be sufficient to deter entities in China from engaging in cyber espionage against U.S. companies. Mitigating the problem will require a multifaceted approach. Many potential actions to address the problem are being discussed by Congress, the Obama Administration, and outside experts. These actions include linking economic cyber espionage to trade restrictions, prohibiting Chinese firms using stolen U.S. intellectual property from accessing U.S. banks, and banning U.S. travel for Chinese organizations that are involved with cyber espionage. To date, Washington has not implemented a comprehensive framework for addressing China's ongoing cyber espionage.

China's Maritime Disputes

Although sovereignty disputes in the East and South China Seas are not new, China's growing diplomatic, economic, and military clout is improving China's ability to assert its interests. It is increasingly clear that China does not intend to resolve the disputes through multilateral negotiations or the application of international laws and adjudicative processes but instead will use its growing power in support of coercive tactics that pressure its neighbors to concede to China's claims. Viewing a public defense of its maritime claims as central to political legitimacy, leaders in Beijing exploit deep-seated popular nationalism to support foreign policy aims in the East and South China Seas. China also views sovereignty over the East and South China Seas as critical to its national security, territorial integrity, and economic development. China has been more assertive since the publication of the Commission's 2012 Report, offering counterclaimants the choice of either facing the brunt of Chinese power as a result of challenging Chinese claims or benefitting from economic and political rewards for moderating their positions or even acquiescing to China's claims. Chinese official statements and use of maritime law enforcement rather than military forces suggest Beijing prefers to avoid direct military conflict over its maritime disputes and rely on the shift in the balance of regional power in its favor to resolve its maritime disputes in the long term.

The East China Sea dispute involves China, Japan, and Taiwan. The dispute can be divided into two distinct issues: territorial sovereignty over the Senkaku Islands (known as the Diaoyu Dao in China, and Diaoyutai in Taiwan), and demarcation of maritime zones that have implications for natural resource rights. Given the historical animosity between China and Japan and the strong nationalist sentiment on both sides regarding the sovereignty of the islands, the Senkaku Islands dispute is especially intense. The Japanese government's September 2012 purchase of three of the islands from a private Japanese owner angered China, sparking an escalation in tensions between China and Japan. PLA Navy and Chinese maritime law enforcement activity near the Senkaku Islands, previously irregular and sporadic, increased to a robust and near-persistent presence following Japan's purchase of the islands. Tensions continued to simmer throughout 2013 as both sides enhanced their naval and maritime law enforcement presence in the disputed waters to assert their claims.

The South China Sea dispute involves China, Taiwan, Vietnam, the Philippines, Malaysia, and Brunei. Beijing denotes its claim on its South China Sea maps using a nine-dash line, with an additional dash off the coast of Taiwan to demonstrate its sovereignty over Taiwan. China's diplomatic preference on the South China Sea is to "divide and conquer" by negotiating the issue on a bilateral basis rather than under the auspices of multilateral forums such as ASEAN.

In addition to boosting its presence in the East and South China Seas, Beijing has taken a number of steps since mid-2012 to address shortcomings in its coordination of maritime policy to better align China's maritime activity with national policy. In an effort to

streamline its maritime policy-making bureaucracies to manage its maritime disputes more effectively, China created a high-level policy advisory group on maritime security issues in mid-2012 and consolidated multiple maritime law enforcement agencies into a single China Coast Guard in mid-2013.

Beijing discourages and seeks to prevent the diplomatic involvement of the United States in the East and South China Seas because Beijing considers these disputes bilateral issues between China and each claimant. However, U.S. treaty commitments and forward-deployed military presence bind the United States to the region in ways that link its security interests to the peaceful resolution of China's maritime disputes. Despite a generally improving military-to-military relationship, mutual mistrust about one another's long-term intentions continues to pervade the overall security relationship. This strategic backdrop poses challenges for the operational environment at sea, especially as the maritime operating areas of the two countries increasingly overlap.

Conclusions

Military and Security Year in Review

- PLA modernization is altering the security balance in the Asia Pacific, challenging decades of U.S. military preeminence in the region.
- The PLA Navy is in the midst of an impressive modernization program. China's acquisition of naval platforms, weapons, and systems has emphasized qualitative improvements, not quantitative growth, and is centered on improving its ability to strike opposing ships at sea and operate at greater distances from the Chinese mainland. Today, the PLA Navy is able to conduct high-intensity operations in China's immediate periphery as well as low-intensity operations beyond the region. Trends in China's defense spending, research and development, and shipbuilding suggest the PLA Navy will continue to modernize. By 2020, China could have approximately 60 submarines that are able to employ submarine-launched intercontinental ballistic missiles or antiship cruise missiles and approximately 75 surface combatants that are able to conduct multiple missions or that have been extensively upgraded since 1992.
- The PLA is rapidly expanding and diversifying its ability to strike U.S. bases, ships, and aircraft throughout the Asia Pacific region including those that it previously could not reach, such as U.S. military facilities on Guam.
- The PLA's expanding involvement in real world missions allows it to field-test equipment and obtain hands-on experience in areas such as addressing unconventional threats in harsh and potentially hostile environments, satisfying expeditionary logistics requirements, and integrating into multilateral operations.
- The PLA is improving its day-to-day readiness levels and conducting longer-range and more frequent, robust, and realistic

training. As these reforms continue, the PLA will become more proficient and confident operating its advanced platforms and weapon systems and better able to rapidly respond to regional contingencies.

- The PLA Navy's growing presence in foreign EEZs contradicts its longstanding policy on military activities in its own EEZ. Rather than resolve the inconsistency between its actions and policy, Beijing likely will continue to assert its authority to regulate U.S. military activities in its EEZ.

China's Cyber Activities

- The Chinese government is directing and executing a large-scale cyber espionage campaign against the United States and to date has successfully targeted the networks of U.S. government and private organizations, including those of DoD and private firms. These activities are designed to achieve a number of broad economic and strategic objectives, such as gathering intelligence, providing Chinese firms with an advantage over their competitors worldwide, advancing long-term research and development objectives, and gaining information that could enable future military operations.
- China has not reduced its cyber intrusions against the United States despite recent public exposure of Chinese cyber espionage in technical detail. This suggests Beijing has decided to continue its cyber campaign against the United States.
- Developments in cloud computing in China may present cybersecurity risks for U.S. users and providers of cloud computing services. The relationship between China's Ministry of State Security and the Chongqing Special Cloud Computing Zone represents a potential espionage threat to foreign companies that might use cloud computing services provided from the zone or base operations there. In addition, the plan to link 21Vianet's data centers in China and Microsoft's data centers in other countries suggests the Chinese government one day may be able to access data centers outside China through Chinese data centers.
- There is an urgent need for Washington to take action to prompt Beijing to change its approach to cyberspace and deter future Chinese cyber theft. Actions and policies under discussion include the following: passing new legislation or modifying existing legislation; changing the cost-benefit calculus of Chinese cyber actors and China's leaders through sanctions and counterintelligence tactics; undertaking multilateral measures; appointing a Cabinet-level official to oversee an interagency process regarding the protection of intellectual property; and enhancing cooperation between the U.S. government and the private sector. These would be more effective if used in combination, as they probably would lead Beijing to make only temporary or minor changes to its cyber espionage activities if used in isolation.

China's Maritime Disputes

- China relies on a coercive and persistent maritime law enforcement and naval presence to gain control of disputed territory in the East and South China Seas. A consolidated maritime policymaking bureaucracy and streamlined maritime law enforcement fleets could increase Beijing's confidence in its capability for coercion in the ongoing maritime disputes.
- Two key drivers shape China's approach to its maritime disputes: First, China encourages ardent popular nationalism, which it exploits to support its foreign policy aims in the East and South China Seas. Second, China views sovereignty over claims in the East and South China Seas as central to its national security, territorial integrity, and economic development.
- China uses legal and administrative measures to assert de jure governance over its disputed maritime regions; it deploys maritime law enforcement and naval vessels to its claimed waters to demonstrate and lay the groundwork for de facto governance.
- Beijing's tendency to demonstrate resolve in its maritime disputes; its large and complicated political, foreign affairs, and military bureaucracy; and its inconsistent adherence to internationally accepted norms of air and maritime operations may contribute to operational miscalculations in the East and South China Seas. Unyielding positions on sovereignty and nationalist sentiment surrounding these maritime disputes increase the risk of escalation from a miscalculation at sea to a political crisis.

Chapter 3: China and the World*China and the Middle East and North Africa*

China employs a multifaceted foreign policy approach to the Middle East and North Africa (MENA). It is characterized by growing economic (and particularly energy) ties; the pursuit of friendly relations with all countries (as well as the Palestinian territories) in the region; the protection of domestic stability and control in China; and the promotion of regional stability in support of China's own domestic economic, political, and security priorities. China has in recent years faced challenges in the region, particularly in responding to political upheaval and regime changes during and after the Arab Spring. China also has taken positions in support of regimes in Syria and Iran that put it at odds with the United States and other regional and international communities.

China is expanding and deepening its trade and investment ties with countries in the region. Between 2003 and 2012, China-MENA annual trade increased more than twelvefold, from \$20.8 billion to \$262.1 billion. In 2009, China overtook the United States to become the world's largest exporter to the region. China's energy demand is the primary driver of these economic ties. MENA accounts for more than 50 percent of China's crude oil imports; these imports are projected to grow in the coming decades. China's leaders view the country's growing reliance on MENA oil imports as a strategic

vulnerability. This sense of vulnerability appears to drive Beijing's efforts to enhance the security of its imports by strengthening its relations with the region's largest oil producers, particularly Saudi Arabia and Iran, but also Iraq, Oman, and others.

China seeks to develop and maintain friendly ties with all MENA countries without being drawn into the region's conflicts and power struggles. As such, China has more or less successfully maintained positive relationships with the major powers in the region, simultaneously strengthening ties with regional rivals like Israel and Iran, Saudi Arabia and Iran, and the Israelis and Palestinians. Beijing's approach generally has been well-received in the region, where China enjoys mainly positive views among leaders and the public.

China also seeks to leverage its relations in MENA in support of its own domestic security, particularly in the Xinjiang Uighur Autonomous Region, home to many of China's ethnic Turkic Muslims. Episodic ethnic and political unrest in Xinjiang has in the past attracted support from overseas Muslim groups in MENA. Beijing fears these overseas groups could encourage or exacerbate what it refers to as "separatist insurgencies" in Xinjiang. To mitigate this perceived risk, China solicits support from countries in the region for its policies to suppress "separatist" activities in Xinjiang.

In addition, China has taken steps to promote stability within MENA. Offers of support for the Israeli-Palestinian peace process, counterpiracy operations in the Gulf of Aden, and participation in UN peacekeeping operations in MENA are among China's contributions to regional security and stability. However, China also has undermined security in the region with its support for the Assad regime in Syria and its continued economic and political ties to Iran.

As China's interests and presence in MENA grow, they inevitably will impact U.S. objectives and influence. Although Beijing has in the past avoided directly opposing Washington on issues related to MENA, this appears to be changing. Beijing's relationship with Tehran and its position on the Syrian conflict seem to indicate that, when key interests are at stake, China is willing to challenge the United States.

Taiwan

Cross-Strait economic ties continue to expand and deepen. From January through July 2013 (the most recent months for which official statistics are available), the total value of trade between China and Taiwan was \$71.8 billion. The total value of cross-Strait trade during this period grew by 2.79 percent compared to the same period in 2012. Through the first seven months of 2013, China remained Taiwan's largest export market, accounting for approximately \$47.3 billion worth of exports (26.9 percent of Taiwan's total exports). China followed behind Japan as Taiwan's second-largest source of imports, accounting for approximately \$24.5 billion worth of imports (15.5 percent of Taiwan's total imports). Although China remained the top destination for Taiwan FDI in 2012, Taiwan's approval of \$10.9 billion in investments in China in 2012 represented a 16.6 percent decrease from the previous year and a three-year low. From January through July 2013, the value of Taiwan FDI to China continued to decrease, slipping 17.23 percent from the pre-

vious year. Officials at the American Institute in Taiwan (AIT), which serves as the de facto U.S. embassy in Taiwan, told the Commission that Taiwan businesses increasingly are looking for investment opportunities in Southeast Asia, Africa, and Latin America as manufacturing costs in China continue to rise. Mainland investment in Taiwan continued to grow in the first seven months of 2013, with the value of investments increasing 79.34 percent compared to the same period in 2012.

In 2013, Taiwan used creative diplomacy to secure participation in a key international organization and to sign two free trade agreements despite China's continued efforts to restrict Taiwan's full participation in the international community. The president of the UN's International Civil Aviation Organization (ICAO) in September 2013 invited a Taiwan delegation to attend the upcoming ICAO assembly as his "guests." Furthermore, Taiwan and New Zealand signed a free trade agreement in July 2013, which marks Taiwan's first such deal with a country with which it does not have official diplomatic relations; Taiwan and Singapore agreed in principle to a free trade agreement in May 2013; and Taiwan is participating in negotiations with 22 other WTO members, including the United States, on a multilateral Trade in Services Agreement. Taiwan's Ministry of Economic Affairs told the Commission that Taiwan's efforts to expand its trade ties with the Asia Pacific region are part of Taiwan President Ma Ying-jeou's larger push to diversify Taiwan's economic partners to avoid overreliance on China. Other Taiwan officials explained to the Commission that the agreements will help promote Taiwan's inclusion in Asia's broader economic integration, including participation in multilateral trade pacts such as the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.

In April 2013, Taiwan and Japan signed a fisheries agreement after 17 years of intermittent negotiations. President Ma said the agreement demonstrates Taiwan's constructive role in reducing tension in the East China Sea without compromising Taiwan's maritime claims and could be used as a blueprint and impetus for a similar agreement between Taiwan and other countries with claims in the South China Sea.

In March 2013, the Philippine Coast Guard opened fire on a Taiwan fishing boat operating in disputed waters in the South China Sea, resulting in the death of a Taiwan fisherman and sparking a diplomatic row with Taiwan. Manila and Taipei both assert the incident took place within their respective exclusive economic zones in the South China Sea. After Taiwan claimed that the Philippines failed to adequately address its demands in the aftermath of the shooting, Taiwan stopped accepting new Filipino labor applications; suspended trade, fishery, and technology exchanges with the Philippines; and removed the Philippines from Taiwan's visa waiver program. Taiwan removed the sanctions in August after the Philippines offered an official apology on behalf of the Philippine president, agreed to pay compensation to the victim's family, and recommended homicide charges for the Philippine Coast Guard personnel who opened fire on the Taiwan fishing boat. Taiwan and the Philippines also are discussing measures to reduce the risk of fu-

ture incidents and working to establish a bilateral fisheries mechanism.

Taiwan's ability to defend against China's growing military capabilities is declining. The key shortcoming in Taiwan's defensive capabilities is its inability to survive initial Chinese air and missile strikes due to insufficient infrastructure hardening and lack of mobile systems. China's overwhelming quantitative and qualitative advantage over Taiwan also will challenge the Taiwan military's ability to sustain high-intensity operations during a conflict. Nevertheless, Taiwan's defense budget continues to decline. Taiwan's official defense budget contracted to \$10.5 billion in 2013 from \$10.6 billion in 2012. Taiwan's 2013 defense spending represents 2.1 percent of its GDP, a record low matched only in 2006 and 2011. This is less than 3 percent of GDP—the level at which President Ma pledged to maintain defense spending—and marks a substantial decrease from 3.8 percent of GDP in 1994. In response to concerns about Taiwan's declining defense budget relative to GDP, President Ma has explained defense spending cannot be expected to keep pace with Taiwan's GDP growth. Taiwan's GDP growth rate was 10.7 percent in 2010, 4 percent in 2011, and 1.3 percent in 2012.

Despite warming cross-Strait ties, China continues to engage in aggressive espionage activities against Taiwan. Since September 2012, Taiwan has arrested at least six former or active Taiwan military officers, including one flag officer, for espionage. In one case, a former Taiwan Navy officer may have provided to China classified submarine nautical charts as well as hydrographic information about the waters surrounding Taiwan. These cases underscore the breadth and depth of China's espionage activities against Taiwan and highlight the increasing counterintelligence risks to Taiwan and U.S. military information shared with Taiwan.

The recent cross-Strait rapprochement benefits the United States by reducing the likelihood of a U.S.-China conflict over Taiwan; contributing to peace, prosperity, and stability in East Asia; and allowing U.S. policymakers to focus their time and attention on other priorities in the U.S.-China and U.S.-Taiwan relationships. At the same time, warming ties between China and Taiwan raise concerns for Washington and Taipei. Increasing cross-Strait economic integration will continue to tie Taiwan closer to China. This could strengthen China's bargaining power over Taiwan and allow China to make progress toward its long-term goal of unification. Responding to these concerns, officials from Taiwan's National Security Council insisted to the Commission that Taipei's economic engagement with Beijing is carefully calibrated to promote both Taiwan's economic growth and continued autonomy.

Macau

The gaming sector is the most important element of the Macau Special Administrative Region (SAR) economy and is the highest-grossing gambling location in the world. Tax collections from the gaming sector in 2012 totaled \$13.9 billion, which accounted for 87.5 percent of total government revenue. Macau's casino-oriented economy and its proximity to the PRC present a significant risk of money laundering. The main channel for money laundering is in the gaming sector through underregulated junket operators and

their affiliates, which include the underground banking system that supports their operations.

Junket operators in Macau are significantly more involved in gambling operations than is common throughout the world, operating with far fewer restrictions. Macau's independent junket operators and independent VIP rooms are not subject to the same regulatory requirements as casinos. There is a risk of money laundering within the independent VIP gaming room operations which are physically conducted within the casinos but can remain outside of the casino's official oversight. The risk is enhanced because so much of the money that is wagered in Macau goes through the loosely regulated independent VIP rooms. In 2012, VIP baccarat rooms in Macau casinos accounted for 69.3 percent of total revenue from games of chance.

A 2007 evaluation by the Financial Action Task Force recognized the risk of money laundering in Macau's gaming sector and noted multiple deficiencies in its anti-money-laundering and counter-terrorist-financing framework. The evaluation also discovered several specific deficiencies in Macau's compliance with the Financial Action Task Force recommendations, including the refusal to respond to foreign requests to freeze assets, the inability to effectively implement UN Security Council resolutions on the financing of terrorism, and the inability of Macau's Customs Service to investigate money-laundering cases.

Since the report was published in 2007, there remain significant vulnerabilities with unlicensed junket operators and the junket affiliates that play an integral role in Macau's gaming system. Macau's junket operators are not subject to the same transparency requirements as casinos, and strict privacy controls prevent U.S. regulators from obtaining information on individuals operating in Macau subsidiaries of U.S. parent casinos. The Macau SAR Gaming Inspection and Coordination Bureau, Macau's gaming regulator, does not disclose financial information. The lack of information presents difficulties in determining the origin of money flowing through such operations, and U.S. state regulators do not have the authority or resources to independently conduct investigations in Macau or other foreign jurisdictions.

The PRC's capital controls have caused more money to cycle through Macau due to Macau's thriving VIP gaming industry, which relies on junket operators and their affiliates to facilitate cross-border money transfers for clients via underground banks. However, Beijing is beginning to take some measures to restrict illicit cross-border transfers and money laundering in Macau as part of the nationwide crackdown on corruption promoted by PRC President Xi.

Hong Kong

The most significant problem for democratic rights activists is the Hong Kong government's lack of progress toward ensuring universal suffrage in the election of the Legislative Council and the chief executive (Hong Kong's highest office). At present, the chief executive is chosen from a slate of nominees by a 1,200-person election committee. The Basic Law states that the ultimate aim for chief executive elections is through universal suffrage, and current

Chief Executive Leung Chun-ying (CY Leung) has indicated that the city is working toward this goal. In March 2013, Chief Executive Leung said in meetings with Chinese President Xi that he was committed to the process of achieving universal suffrage in Hong Kong by 2017. In July he also promised free and open elections for the Legislative Council by 2020.

Despite these stated goals, the dominance of the Hong Kong government by politicians allied to Beijing has stymied progress in achieving universal suffrage. The current election committee is heavily populated with business figures as well as politicians and labor leaders with strong connections to Beijing, giving it a distinctly pro-Beijing slant. Beijing effectively controls roughly 950 of the 1,200 election committee votes for chief executive. Currently, 30 members of the 70-person Legislative Council are elected by traditional functional constituencies, in which professionals in specific fields such as insurance, transportation, health care, finance, and tourism are allowed to cast a vote in addition to their vote in their geographic constituency. The greater representation of some segments of society as a result of the functional constituencies, combined with the dominant support for pro-Beijing candidates among functional constituency voters, ensures that the Legislative Council remains controlled by pro-Beijing representatives.

Between 2005–2012, Hong Kong's Freedom House ranking for press freedom fell from a status of "free" to "partly free." The Hong Kong press itself reports a sense of diminishing freedom. Following the election of Mr. Leung to chief executive in 2012, press freedom advocates reported an escalation in government efforts to censor and control media access to official information. Free press advocates contend that the government has reduced the number of full press conferences it holds for Hong Kong media, thereby denying journalists the opportunity to ask questions. Media self-censorship is also a pervasive concern. A poll conducted in May 2013 by the Public Opinion Program of the University of Hong Kong found that 48 percent of respondents believed that the local news media practiced self-censorship. Self-censorship has increased as the Chinese central government has co-opted media company owners. According to the 2013 annual report of the Hong Kong Journalists Association, roughly 50 percent of Hong Kong media owners have been appointed to the National People's Congress or the Chinese People's Political Consultative Conference.

Newly proposed legislation would further limit journalists. An antistalking bill that may be considered this year could hinder journalists' ability to seek out information from sources. Another law would limit personal data that corporate directors must make public. While supporters argue that this law is important for enhancing protections of individual personal data, detractors are concerned that it will unduly shield directors from media scrutiny.

Police surveillance is also a growing concern in Hong Kong. The 2006 posthandover Interception of the Communications and Surveillance Ordinance granted police broader and more explicit authority to conduct physical and communications surveillance for the sake of public security. The introduction of police cameras comes at a time when protests against the Hong Kong leadership are up sharply. In addition to the Occupy Central efforts and the rallies

against the national education proposal, thousands of Hong Kong residents have participated in protests calling for the resignation of Chief Executive Leung. Pan-Democratic legislators meeting with Commissioners in Hong Kong reported that police are now monitoring and arresting prodemocracy demonstrators as much as 12 to 24 months after their participation in political events. In July 2013, for example, Yau Ka-yu was reportedly arrested and charged with illegal assembly in relation to her 15-month-old participation in an April 2012 protest outside the China Liaison Office in Hong Kong.

Conclusions

China and the Middle East and North Africa

- China is expanding and deepening its trade and investment ties with countries in MENA. More than half of China's crude oil imports are from MENA producers, and China increasingly looks to the region as an export market for manufactured goods and services.
- Energy security is a key driver of China's engagement in MENA. As China's continued economic growth becomes more dependent on a steady supply of oil and natural gas from the region, Beijing likely will augment already robust economic ties with stronger political and security engagement.
- China, driven primarily by its growing demand for energy, seeks to promote a framework for stability in MENA that supports its own economic, political, and security interests. These efforts include supporting the resolution of the Israeli-Palestinian conflict, conducting counterpiracy operations, and participating in UN peacekeeping missions. Conversely, China's position on the Syrian conflict and its support for Iran undermine peace and stability in the region.
- China struggled to diplomatically adapt to regime changes across MENA during and after the Arab Spring. Beijing's instinct has been to support sitting regimes in Egypt, Libya, and Syria and to oppose international intervention in these countries.
- Most MENA governments appear to judge China plays a positive role in the region. Oil- and natural gas-producing states in particular look to China as their future primary market. Moreover, governments in China and some MENA countries appear to share similar stances on issues of sovereignty, human rights and democracy, and the role of the state in the economy. However, many MENA countries have criticized China for its support for the Assad regime in Syria.
- Historically, China largely has avoided challenging U.S. influence and power in the Middle East. In recent years, however, when key Chinese interests are at stake, China has made use of its permanent membership in the UN Security Council to oppose U.S. policies and objectives in the region.

Taiwan

- Cross-Strait economic, cultural, and educational ties continue to expand and deepen. However, domestic political dynamics and priorities in China and Taiwan still constrain movement on political and security issues.
- Since the Commission's 2012 report, Taiwan has used creative diplomacy to sign two free trade agreements and secure participation in a key international organization. Taiwan's expanding international space helps the country counterbalance its economic reliance on China by increasing its competitiveness in the world economy, raises the cost to Beijing of military coercion against Taiwan, and promotes regional stability.
- President Ma since his reelection in January 2012 has accelerated efforts to increase Taiwan's economic engagement with the United States and gain U.S. support for expanding Taiwan's international space, while continuing to advocate for future U.S. arms sales.
- Taiwan's military over the last decade has improved its ability to conduct joint operations and has developed some asymmetric capabilities. However, China's rapid military modernization during this time has outpaced these improvements and negated many of the military advantages Taiwan previously held over China.

Macau and Hong Kong

- The rapid inflow of money to Macau, its casino-oriented economy, and its proximity to the PRC present a significant risk of money laundering and financing of terrorism, particularly in the underregulated shadow banking and junket system supporting the VIP gaming business in Macau.
- A combination of the PRC's strict capital controls and restrictions on the collection of gambling debts has given rise to grey market alternatives to facilitate the movement of gambling funds into Macau. Gambling debt collection conducted by unregulated third-party affiliates in the Mainland is susceptible to organized crime and violence.
- Macau's junkets with alleged criminal affiliations present legal risks for U.S.-licensed casinos operating VIP rooms in Macau. Casinos found to be working with junkets directly or indirectly associated with Asian organized crime may be subject to revocation of their state-issued license to operate in the United States.
- Macau's loose regulation of the junket system and its strict privacy law prevent U.S. regulators from accessing information they are accustomed to, and U.S. state regulators lack the authority and resources to independently conduct investigations in foreign jurisdictions. This prevents U.S. regulators from accurately accessing the situation in Macau and effectively stops them from evaluating individuals conducting business with U.S.-licensed casinos.

- Macau's anti-money-laundering and counter-terrorist-financing framework has fallen short in complying with internationally recognized standards. Numerous vulnerabilities remain in its regulations, including deficiencies relating to Macau's inability to effectively freeze financial assets and its inadequate inspection and oversight of casinos and junket operators and promoters.
- Despite reports that the PRC aims to more closely monitor Macau's gaming industry as part of its nationwide initiative to crack down on corruption, there is no substantial evidence to suggest that Beijing intends a crackdown on illicit money transfers and money laundering in Macau.
- To protect their licenses to do business in the United States, American casinos have adopted a number of measures designed to prevent illegal activities in their VIP rooms. The Commission is not in a position to evaluate whether those measures are fully adequate to insulate the operations of those rooms from illegal activity.
- Despite official statements of support from Beijing and the Hong Kong chief executive, the continued lack of meaningful progress calls into question Beijing's real intentions. Prospects for universal suffrage by 2017 are dimming. Political interference, government restraints on access to information, and self-censorship continue to take a toll on press freedom in Hong Kong. Public perceptions of media credibility have declined since the handover. Violent attacks on prodemocracy news outlets and their owners are on the rise, and the totality of the evidence suggests that Beijing does not intend to allow real democracy to develop in Hong Kong.
- Prodemocracy activists express alarm over stepped-up police surveillance at protests, which they fear may be aimed at chilling public discourse or quelling public dissent.
- All of these trends run counter to the Basic Law's assurances that Hong Kong's traditional democratic and civil rights would be preserved for the first 50 years following the handover.
- The systematic disenfranchisement of those who support greater democratic freedoms and civil liberties has created a climate of political polarization that may undermine Hong Kong's fundamental governability.

THE COMMISSION'S KEY RECOMMENDATIONS

The Commission believes that ten of its 41 recommendations to Congress are of particular significance. The complete list of recommendations appears at the Report's conclusion on page 397.

The Commission recommends:

- Congress fund the U.S. Navy's shipbuilding and operational efforts to increase its presence in the Asia Pacific to at least 60 ships and rebalance homeports to 60 percent in the region by

2020 so that the United States will have the capacity to maintain readiness and presence in the Western Pacific, offset China's growing military capabilities, and surge naval assets in the event of a contingency.

- Congress ensure that the Food and Drug Administration (FDA) makes it a priority to increase the number of physical inspections of Chinese food imports at the border; to increase the rigor of those inspections to include testing for pathogens and chemical, pesticide, and drug residues, and processed food ingredients; and to conduct more frequent and thorough inspections in food facilities in China. Congress should also urge the U.S. Department of Agriculture (USDA) to permanently assign inspection personnel to China so that the exporting plants receive regular visits by USDA inspectors.
- Congress direct the Department of Commerce to develop a comprehensive, ongoing inventory of Chinese foreign direct investment (FDI) in the United States and, on an annual basis, update the inventory. The inventory should identify the ownership structure of the entity engaging in the investment. In preparing the inventory, the department should call on private sector entities engaged in monitoring Chinese investments in the United States and such other entities to ensure that its report is complete and accurate. The department should prepare a comprehensive report to Congress on an annual basis identifying the FDI by Chinese entities that were made in the previous calendar year. In its report, the department should indicate those investments that received any assistance from the "Select USA" program. The department should also identify, on an ongoing basis, the lines of commerce that each of the investments are engaged in.
- Congress direct the Administration to prepare an inventory of existing federal use of cloud computing platforms and services and determine where the data storage and computing services are geographically located. Such inventory should be prepared annually and reported to the appropriate committees of jurisdiction.
- Congress assess whether to amend the Committee on Foreign Investment in the United States (CFIUS) statute to allow review of greenfield investments for threats to U.S. national security.
- Congress require the USDA and the U.S. Trade Representative (USTR) to conduct a comprehensive review of China's agricultural subsidies, discriminatory taxes, state trading, and procurement practices; take account of the damages incurred by U.S. farmers and downstream industries; and suggest appropriate remedies.
- Congress fund departments of Defense and State efforts to improve the air and maritime capabilities of U.S. partners and allies in Asia, particularly with regard to intelligence, surveillance, and reconnaissance, to improve maritime domain awareness in the East and South China Seas.

- Congress assess the extent to which existing laws provide for inadequate or ineffective remedies against the anticompetitive actions of Chinese state-owned or state-invested enterprises operating in the U.S. market. Additional remedies may be required to account for the fact that these enterprises may not be operating based on commercial considerations.
- Congress empower the Securities and Exchange Commission (SEC) to set minimum standards for companies listing and maintaining listings on U.S. exchanges and enable the SEC to directly delist foreign companies not in compliance with these standards.
- Congress urge the Administration to expedite progress in its implementation of Section 806 of the National Defense Authorization Act for Fiscal Year 2011 (Public Law 111–383), which was intended to enhance the Department of Defense’s ability to address supply chain risks.